Policy Recommendations

In January 1996, the FCC adopted a *Policy Statement on International Accounting Rates*, in which it recognized the need to update U.S. accounting rate policies, including the international settlements policy, "...to directly address the dilemmas posed by the changing character of the world market."[66] The FCC acknowledged the need to heighten the guard against market distortions. As a way of encouraging a more efficient international market, the FCC endorsed:

> "Increasing regulatory support for new services that encourage arbitrage in the international market, and tailoring accounting rates policies to reflect diverse national market structures; in monopoly markets, take stronger measures to reduce accounting rates with countries making little progress toward significant reform of these rates; in competitive markets, consider major alternatives for providing international services, including the option of end-to-end service by a single supplier without the use of accounting rates; in the case of developing countries which agree they must reform their accounting rates and introduce competition, consider mechanisms to assist with periods of transition."[67]

Just as the Commission is taking proactive measures to avert the possibility of cross-subsidization and price squeezing in the intra-LATA market, it should enact policies that eliminate the potential for price squeeze in the international services market, while also allowing the industry to develop according to market forces. In essence, when the international structure of communications service firms permits them to create transfers that mirror the price squeeze behavior well documented in the domestic competition, theory overwhelmingly advocates taking steps to prevent this type of monopolistic practice.

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[66] Federal Communications Commission, *Policy Statement on International Accounting Rate Reform.* FCC 96-37. January 31, 1996.

[67] Federal Communications Commission, *Policy Statement on International Accounting Rate Reform.* FCC 96-37. January 31, 1996.

Determining "Cost-Based" Rates

Attaining cost-based interconnection is, and will probably always remain, an unreachable goal. However, it is a goal worth pursuing. Determining LRIC on a country-by-country basis is a daunting, but not impossible, task. The cost of each network component should be determined through international data, as well as averages of known sources. When data is not available, the Commission should assume that the network and firm are both operating efficiently. There is no justification for making U.S. consumers pay for the inefficiencies of other countries.

Evidence from both the ITU and private consultancies shows the average LRIC of terminating international traffic to be no greater than 8 cents. The Commission should consider establishing a ceiling close to this rate for all countries, in order to ensure that the potential for price squeeze is kept to an absolute minimum. In addition, a rate in this range should be applied to all countries, regardless of economic development. As the ITU recognized, there is little evidence to support the myth that developing countries have higher costs associated with lower traffic volumes. Furthermore, it must be remembered that developing countries collect the largest portion of the United States' above-cost outpayments and, in the future, they stand to increase their take significantly. Allowing these countries to continue pricing the accounting rates above-cost would result in significantly less declines in settlement payments (and anticompetitive practices) than otherwise could, and should, be attained.

Furthermore, the Commission should place the onus on foreign firms to prove that their true LRICs are greater than the benchmark set by the Commission. Doing otherwise would place dominant foreign firms in control of the process, because U.S. firms would not be able to obtain information necessary to counter the claim.

The Myth of a Transition Period

Many have argued that any accounting rate reductions should be implemented over a period of time to allow foreign countries to adjust, (e.g. rebalance domestic tariffs, find other funding sources for local service, and the like). While good intentioned, these benevolent goals cloud the fact that above-cost accounting rates are a transfer from U.S. firms and consumers to foreign firms and consumers. It ignores the fact that not all of this money is used for improving local infrastructure or maintaining low phone service. In fact, there is simply no public record of how this money is spent in developing countries. This also ignores the potential for firms to use these monies to practice anticompetitive behavior in the United States.

For every dollar sent overseas in the form of above-cost accounting rates, a dollar of extra investment, revenue, or savings is taken out of this country. American consumers do not have a responsibility to continue

making overpayments so that telephone monopolies can make rebalancing and other adjustments. It would be equally unfair to force a firm who catches a contractor making overcharges to continue paying the overcharges until the contractor finds another line of work.

It is simply not in the interest or duties of the Federal Communications Commission to grant extended periods of time for foreign countries to adjust to rules and regulations made to ensure low prices and fair competition in the United States.

Enforcement Mechanisms

The Commission should also act to ensure that this policy is followed by all firms through an effective enforcement mechanism. This can only be achieved by establishing an incentive based system of punitive actions if violating firms are found to be ignoring the Commission's rules. If foreign firms are unwilling to accept settlement rates within the FCC's established benchmarks, the Commission should direct U.S. firms to settle below the actual benchmark at an "off-the-shelf" rate. This rate should not be lifted until an agreement is reached setting the settlement rate at or below the benchmark for that country. Since transition periods are seen as counterproductive to a strategy of promoting low prices in the United States, no interim reductions in accounting rates that do not meet the benchmark should be considered acceptable.

Policy Action in Lieu of a WTO Negotiations

The major priority of U.S. policymakers should be to secure a market opening agreement at the World Trade Organization's Negotiating Group on Basic Telecom, scheduled to conclude February 15, 1997. A pro-competitive agreement that liberalizes markets to internal and foreign competitors will significantly reduce the problems associated with price squeezing. However, an agreement will not suffice to eliminate the potential for price squeeze behavior in the U.S. market. Firms with dominant market power in their home market will continue to generate revenue from above-cost accounting rates and have the ability to apply them to their U.S. subsidiaries, under the WTO framework.

In the negotiations, it is imperative to stress that anticompetitive measures guarding against price squeeze abuses is complementary to the goals of all countries negotiating at the WTO and something all countries may wish to pursue. Anticompetitive restrictions are, in fact, a crucial component of any serious effort to liberalize telecom markets. Tying cost-based accounting rates to use of licenses is, in fact, a course of action that all countries intent on rapidly injecting competition into the telecom sector should consider. A competitive international market could quickly move traffic flows, particularly in smaller countries, and create price squeeze problems for other countries.

Absent a WTO agreement, it is imperative that the effective competitive opportunity (ECO) test be maintained in order to ensure that foreign-affiliates who enter the United States market are not able to practice discriminatory behavior arising from asymmetrical market access.

Conclusions

The telecommunications industry is in the midst of a global revolution that today's regulatory environment is struggling to keep pace with. The opening of markets to foreign firms promises to deliver enormous benefits in the form of more competitive markets, greater innovation, and greater consumer choice. Just as regulations need to change in order to embrace these opportunities, they must face the reality that this new era will not immediately be competitive. Firms will possess significant market power in some markets and attempt to leverage that power in competitive markets.

The FCC needs to continue enacting aggressive policies regarding accounting rates. The United States should aggressively pursue market opening agreements while at the same time protecting consumers against anticompetitive behavior such as the price squeeze by insisting on cost-based accounting rates as a precondition for market entry. In addition, the FCC should enact more aggressive benchmarking for accounting rates and enforce these benchmarks with below-benchmark "off-the-shelf" rates that are automatically effective.

Not creating a regulatory regime that protects consumers and firms from price squeeze abuses places an entire country at risk of missing the full benefit of the most important economic and technological occurrence since the industrial revolution.

Appendix A: Scenario Based Forecasting Methodology

Weighted Accounting Rate

The weighted accounting rate is calculated from FCC international traffic data for 1995. The model examined the top 16 routes in terms of total traffic flows, that constitute about two-thirds of all U.S. inbound and outbound traffic. Of the sixteen countries, six can be classified as developed, three are newly industrialized countries, and the remaining seven are developing.[68] The basic equation for each country's weight in the calculation is as follows:

$$\frac{\text{(Total country minutes)}}{\text{(Total minutes of all countries)}} \quad \mathbf{X} \quad \text{Country-specific accounting rate}$$

[68] The top sixteen countries were chosen because they represent a good cross-section of developed and developing countries as well as 65 percent of total traffic flows. These countries will also represent the primary growth routes in U.S. inbound and outbound traffic as competition advances. The model assumes that the weight of each country is static, i.e., that each countries share of U.S. inbound and outbound minutes stays the same over the time period. While there will be some fluctuation, ESI does not believe this will have a major impact on the results.

Weighted Accounting Rate

	Total Minutes	Acct. Rate 1995	Weight 1995	Acct Rate Accelerated 2005	Weight Accelerated 2005	Acct Rate Slow 2005	Weight Slow 2005
WORLD TOTAL							
Canada	5114788655	0.2	0.0648	0.09	0.029156157	0.145	0.046973808
Mexico	2760002736	0.67	0.1171	0.3	0.052443401	0.485	0.084783498
United Kingdom	1711533165	0.21	0.0228	0.09	0.009756362	0.09	0.009756362
Germany	952058968	0.23	0.0139	0.09	0.005427083	0.16	0.009648147
Japan	905818305	0.91	0.0522	0.45	0.02581747	0.68	0.039013066
Dominican Republic	498529056	0.9	0.0284	0.45	0.014208985	0.675	0.021313478
France	538483967	0.35	0.0119	0.09	0.003069555	0.22	0.007503356
Hong Kong	417858812	1	0.0265	0.5	0.013233041	0.75	0.019849561
Korea South	456888307	1.23	0.0356	0.4	0.011575243	0.815	0.023584557
Philippines	344356322	1.2	0.0262	0.4	0.008724251	0.8	0.017448501
India	339169042	1.6	0.0344	0.8	0.017185662	1.2	0.025778493
Italy	384225362	0.52	0.0127	0.15	0.003650374	0.335	0.008152502
Brazil	380748671	1.03	0.0248	0.5	0.012057811	0.765	0.018448451
Taiwan	380276696	1.2	0.0289	0.6	0.014451437	0.9	0.021677156
Colombia	320571888	1.27	0.0258	0.6	0.01218251	0.935	0.018984411
China	283155568	2.13	0.0382	1.117	0.020032648	1.6235	0.029116387
	15788465520		**0.5641**		**0.252971988**		**0.402031733**

Scenario One -- Accelerated Competition Without Cost-based Benchmarking

	U.S. Outbound Traffic	Foreign-Originated Traffic to US	US Growth	Foreign Growth
1995	15.781	7.129		
	17.675	7.842	1.120	1.100
	19.972	8.627	1.130	1.100
	22.399	9.920	1.122	1.150
	25.006	11.409	1.116	1.150
2000	27.916	13.234	1.116	1.160
	31.165	15.351	1.116	1.160
	34.656	17.961	1.112	1.170
	38.538	21.194	1.112	1.180
	42.855	25.433	1.112	1.200
2005	47.656	30.519	1.112	1.200
Average			*1.116871605*	*1.157*

Scenario Two -- Accelerated Competition With Cost-Based Benchmarking

	U.S. Outbound Traffic	Foreign-Originated Traffic to US	US Growth	Foreign Growth
1995	15.781	7.129		
	17.675	7.842	1.120	1.100
	20.379	8.627	1.130	1.100
	23.154	9.862	1.129	1.143
	27.993	11.274	1.128	1.143
2000	33.816	13.001	1.127	1.153
	38.101	14.964	1.125	1.151
	43.137	17.373	1.130	1.161
	48.406	20.345	1.120	1.171
	54.556	24.231	1.125	1.191
2005	61.213	28.859	1.120	1.191
Average			*1.1254*	*1.1504618*

Scenario Three -- Slow Competition Without Cost-Based Benchmarking

	U.S. Outbound Traffic	Foreign-Originated Traffic to US	US Growth	Foreign Growth
1995	15.781	7.129		
	17.675	7.842	1.120	1.100
	19.972	8.627	1.130	1.100
	22.569	9.705	1.130	1.125
	25.548	10.918	1.132	1.125
2000	28.869	12.337	1.130	1.130
	32.536	13.941	1.127	1.130
	36.602	15.823	1.125	1.135
	40.995	18.038	1.120	1.140
	45.709	20.744	1.115	1.150
2005	50.737	23.856	1.110	1.150
Average			*1.124*	*1.129*

Scenario Four -- Slow Competition With Cost-Based Benchmarking

	U.S. Outbound Traffic	Foreign-Originated Traffic to US	US Growth	Foreign Growth	Scenario Three -- Present Co
1995	15.781	7.129			0.62
	17.675	7.812	1.120	1.096	0.6
	20.583	8.540	1.165	1.093	0.58
	23.619	9.549	1.148	1.118	0.09
	27.875	10.678	1.180	1.118	0.08739
2000	32.870	11.970	1.179	1.121	0.08485569
	37.405	13.419	1.138	1.121	0.082394875
	42.773	15.109	1.144	1.126	0.080005424
	48.477	17.089	1.133	1.131	0.077685266
	55.183	19.499	1.138	1.141	0.075432394
2005	62.535	18.846	1.133	0.967	0.073244854
Average			*1.148*	*1.103*	

Assumptions Used to Estimate Demand and Traffic Forecasts

In estimating demand and traffic, both domestic and foreign price trends are considered. Price changes in the United States have a positive impact on outbound demand as well a negative impact on inbound demand. For the purposes of simplicity, all inbound minutes are assigned an elasticity of 3.4 while all outbound minutes are assigned an elasticity of 1.4. The outbound minutes estimates of elasticity are consistent with the findings of Rea and Lage, Yatraski, and A.M. Lago, while the inbound minutes estimate is purposefully high to exaggerate the development of price competition. The substitution effect is assumed to be 10 percent. In other words, change in price differentials cause a 10 percent shift in potential new minute growth (based on the elasticities) from outbound to inbound minutes. The inbound v outbound growth minute estimates for the various scenarios are shown in the following charts.